Consumer Federation of America

November 1, 1994

William F. Caton
Acting Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, DC 20554

Re: Ex Parte Contact in CC Docket No. 94-1; Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

Enclosed herewith please find the original and two copies of two studies by the Consumer Federation of America which should be entered into the record for the above referenced docket. The first study is entitled "Milking the Monopoly: Excess Earnings and Diversification of the Baby Bells Since Divestiture" and the second is "Local Exchange Costs and the Need for a Universal Service Fund: A Consumer View." Both studies have been entered into the Congressional record during hearings held on S. 1822 and H.R. 3626 and H.R. 3636 during the past few months.

CFA is extremely concerned that the Commission get a full picture of the record of over-earnings by the local exchange carriers as well as the rapidly declining costs. These studies will help to assure a complete record is created in this proceeding.

Our research in the first study indicates that the RBOC's have diverted significant resources away from the local network as some states and the Commission have moved from traditional rate of return to a price cap regime. CFA remains concerned that many of the most important goals underlying the shift to price caps, such as increased infrastructure investment, are not being served by the price cap mechanism. Indeed, network investment under price caps has not even kept up with historical trends while revenues have skyrocketed. And this at a time when the companies claim massive infrastructure investment is necessary.

The second study illustrates a different, though related problem. The trend lines indicate that the cost a variety of LEC services are quickly dropping. The fact that some costs are falling annually at rates of near 7-8% would indicate that the productivity factor currently in place is woefully inadequate. In addition, our research indicates that as the costs of providing LEC

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services drops, the revenues and net income from newly deployed technologies such as SS7 will increase significantly.

CFA believes adding this information to the record in this proceeding will help assure that consumers do not continue to be victimized by LEC over-earnings at ratepayer expense. This must be the primary goal as the FCC completes its review and makes the necessary improvements to the current price cap system.

Very truly yours,

Bradley Stillman
Legislative Counsel

cc: Kathleen Wallman
Pete Blevin
Richard Welch
Karen Brinkman
James Coltharp
James Casserly

Consumer Federation of America

MILKING THE MONOPOLY:

EXCESS EARNINGS AND DIVERSIFICATION

OF THE BABY BELLS SINCE DIVESTITURE

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FEBRUARY 1994

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MILKING THE MONOPOLY:
EXCESS EARNINGS AND DIVERSIFICATION OF THE BABY BELLS SINCE DIVESTITURE

EXECUTIVE SUMMARY

This is the seventh report in CFA's series of analyses of earnings of the Regional Bell Holding Companies (RHCs). It documents not only excess earnings, but also the misuse of fund from telephone subsidiaries (Bell Operating Companies or BOCs) for investment in activities unrelated to the public switched network (non-BOC subsidiaries), and the leveraging of monopoly ratepayer cash flow to underwrite the debt of unregulated activities. These financial characteristics of the RHCs take on particular importance in the context of the debate over amending the Communications Act.

- They are one indication, among many, that the BOCs do not face competition at a key intersection on the information superhighway, the local exchange switch.

- They suggest that giving BOCs additional incentives to invest could be money for nothing.

- They indicate that control over the local switch could combine with the ability to leverage ratepayer cash flow to give the Baby Bells significant market power over the information superhighway.

We estimate $4 billion of excess earnings for 1992 alone. With taxes, the burden of excess rates is close to $5 billion.

- This equal $5 per month for every residential line in the nation.

- Cumulatively, since divestiture, the total approaches $35 billion of excess profits, which translates into over $50 billion of overcharges when taxes are included.

- The return on equity enjoyed by the BOCs significantly exceeds not only the other large companies in the economy (see Table ES-1), but also the companies in the sectors of the industries with which

TABLE ES-1:
RETURN ON EQUITY AND CAPITAL STRUCTURE FOR LOCAL EXCHANGE COMPANIES, THEIR POTENTIAL COMPETITORS AND OTHER UTILITIES

	RETURN ON EQUITY				
	FORBES	BUSINESS WEEK			DEBT AS A
	1988-1992	1992	1991	1990	% OF CAPITAL
ALL INDUSTRY	11.5	10.4	9.2	12.5	33
BABY BELL BOC AVG	14.5	14.8	13.0	14.6	29
BABY BELL NON-BOC AVG	4.3	2.6	4.9	8.5	85
OTHER UTILITIES					
ELECTRIC UTILITIES	11.4	11.0	10.0	9.7	38
GAS UTILITIES	10.8	10.2	1.1	6.1	40
OTHER LECS					
GTE	15.3	14.4	14.0	12.9	44
SNET TELECOM	12.2	12.9	10.8	11.9	37
ROCHESTER TEL	13.0	11.7	12.9	11.5	39
CINCINNATI BELL	10.4	5.9	6.7	15.5	30
TELECOMMUNICATION	11.5				33
EQUIPMENT		15.4	3.3	15.9	
COMPANIES		14.4	11.5	13.7	
OTHER NON-UTILITIES					
BROADCAST & CABLE	LOSS	5.4	-1.1	5.1	69
MOVIES	6.5	13.6	11.6	12.9	34
PUBLISHING	11.0	6.9	4.7	7.1	18
ADVERTISING	17.4	19.9	14.0	16.0	27
COMPUTER SOFTWARE	19.2	20.9	18.4	20.1	8
COMPUTER HARDWARE	6.4				10
PERIPHERALS	11.7	-10.3	-1.1	11.0	19
CONSUMER ELCTRNCS	12.6				8
HOME SHOPPING	11.0				20

the Baby Bells seek to compete.

These excess earnings have not been plowed back into the network by the telephone subsidiaries of the Baby Bells. Instead, these economic resources have been funnelled out of the industry in the form of excessive dividends and the acquisition of everything from foreign telephone and cable companies, to domestic cellular companies, to real estate businesses.

- Capital spending as a percentage of cash flow by the BOCs has declined from over 85 percent at the time of divestiture to around 65 percent today (see Figure ES-1).

- Dividends have not declined as a percentage of cash flow and dividend yields are twice as high as the Business Week 1,000 (see Figure ES-1).

Massive resources have been diverted out of the industry.

- Since 1986 the Baby Bells have paid $35 billion in dividends, invested $13 billion to non-telco activities, but only $1 billion in net telco investment (above depreciation charges).

- RHC non-BOC assets of about $35 billion have performed poorly, earning less than a 4 percent return on equity.

These non-BOC assets have been acquired with the direct investment of excess earnings from the operating companies and also by leveraging the monopoly ratepayer to underwrite the debt of non-telephone subsidiaries of the Baby Bells.

- The RHCs carry less than 30 percent debt in their telephone subsidiaries and over 80 percent debt in their unregulated subsidiaries (see Table ES-1).

- This ability to leverage monopoly ratepayers gives the Baby Bells an immense advantage over the other firms in the information age industries, who must carry more equity at risk.

Policymakers have begun to recognize the importance of restoring balance in the treatment of ratepayers in order to prevent abuse as well as create a level playing field for competitors as the information age is opened. The indications include

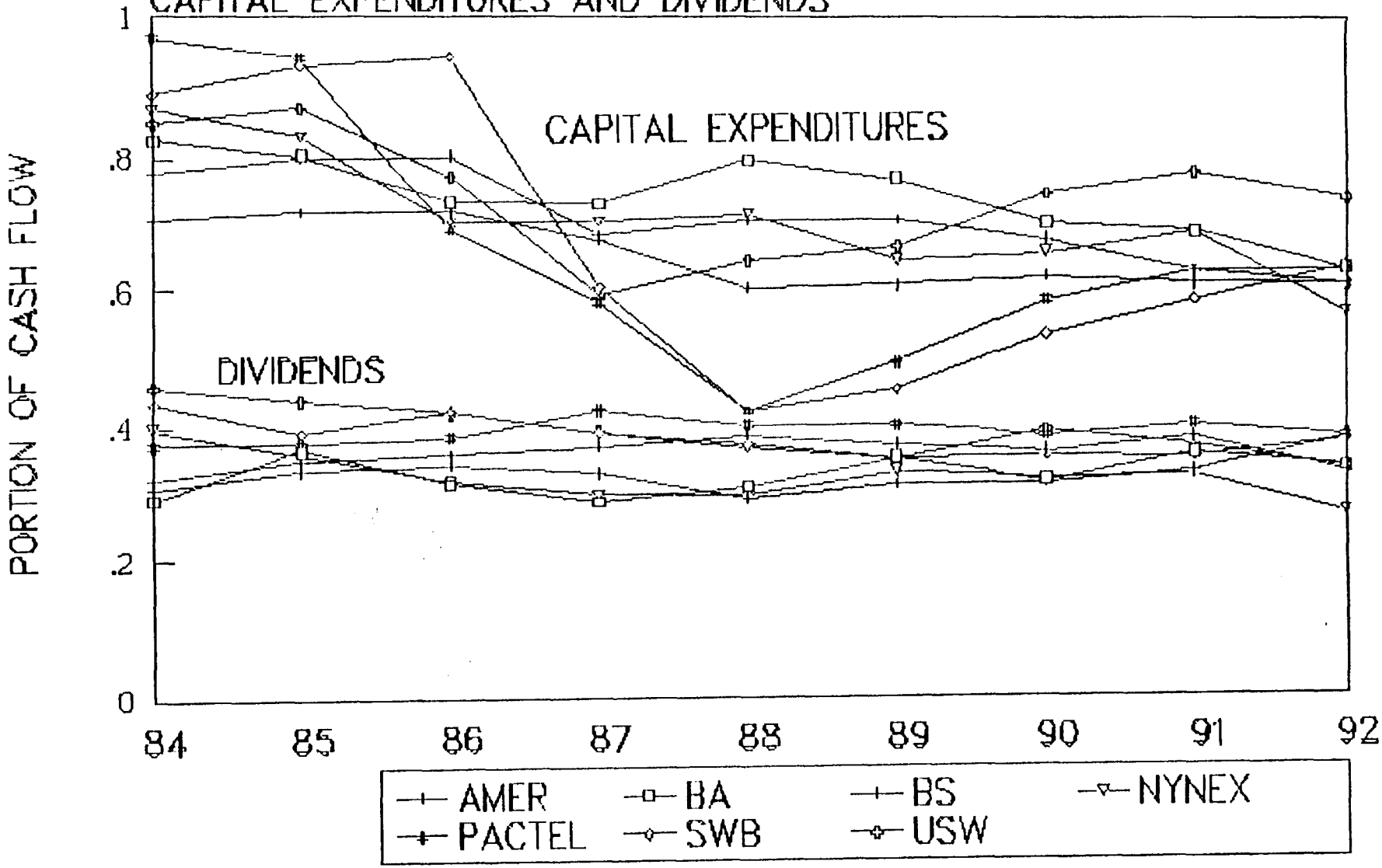
- A commitment to reasonable rates based on a cost-based allocation between competitive and monopoly services which could begin to address the problem of excess earnings.

- Structural separations, which prohibit leveraging BOC assets, could beginning to address the problem of unequal access to financing.

- Elimination of market power prior to entry by the Baby Bells into other lines of business, to reduce the leverage over the local bottleneck.

FIGURE ES-1

RBOC CASH FLOW USED FOR
CAPITAL EXPENDITURES AND DIVIDENDS



I. INTRODUCTION

Over the past decade the Consumer Federation of America (CFA) has charted the excess earnings of the Regional Bell Holding Companies (RHCs) and the misuse of those funds for investment in activities unrelated to the public switched network.[1] At a time when Congress is debating what activities to allow the RHCs into and whether it is necessary to stimulate additional investment in the information superhighway, an understanding of the financial resources of the Baby Bells and what they do with them is crucial.

This seventh study in our series extends our previous analysis of the excessive earnings of the Baby Bells in several directions.

- It updates our estimates of the amount of excesses earned by the Baby Bells.
- It explores in greater detail the diversion of resources out of the industry.
- It examines the capital structures used to gain leverage in non-telephone businesses.
- It adds a new dimension to the analysis by looking at the capital structure and economic performance of the information industry segments with which the Baby Bells claim to be competing.

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[1] CFA first noted rising prices as a source of concern less than a year after the break-up in Gene Kimmelman and Mark Cooper, Divestiture One Year Later, December 19, 1984. Major analysis of excess earnings were conducted in Dr. Mark N. Cooper, Local Rate Increases in the Post Divestiture Era: Excessive Returns to Telephone Company Capital, September 1986; "Comments of the Consumer Federation of America," In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, before the Federal Communications Commission, CC Docket No. 87-313, October 19, 1987; "Joint Comments of the International Communications Association and the Consumer Federation of America, In the Matter of Access Tariff Filing Schedule, Before the Federal Communications Commission, CC Docket No. 88-326, June 22, 1988; "Joint Comments of the International Communications Association and the Consumer Federation of America, In the Matter of Comprehensive Study of the Domestic Telecommunications Infrastructure, Before the National Telecommunications and Information Administration, Docket No. 91296-9296, April 9, 1990; and most recently in Dr. Mark N. Cooper, Divestiture Plus Eight: The Record of Bell Company Abuse Since the Break-Up of AT&T, December 1991.

II. WHERE DOES ALL THE MONEY COME FROM?

A. TURNING HISTORY ON IT HEAD

Traditional rate of return regulation allowed utilities an opportunity to earn a stable return on investment. The target rate of return was set to be commensurate with the risk of the investment, which was small in a monopoly environment. There was no guarantee that the allowed rate of return would be achieved, however, and the utility was supposed to work hard to hit its target.

In the decades before divestiture, telecommunications investment by AT&T earned a stable rate of return that was between one and two percentage points below that of the manufacturing sector as a whole (as Figure II-1 shows).[2] The fact that AT&T's return was substantially below the average for the manufacturing sector reflects the fact that AT&T faced less risk in its franchise monopoly businesses than other businesses did.

At the same time, the allowed rate of return and the achieved rate of return were well above the 10-year treasury bond rate. This is a relatively risk free investment of a term similar to that for utility stocks. Historically, the risk premium was a few percentage points. In particular, in the decade or so prior to divestiture, AT&T earned only two points above the T-bond rate.

Since divestiture this pattern has been turned on its head by the Regional Bell Operating Companies (RBOCs). They have earned over seven points above the T-bond rate and two points more than all manufacturing companies. The swing in comparison to firms in the manufacturing sector, who face much greater competition than local telephone companies, is striking. In 1992, the RBOCs earned 8 percentage points above the ten year T-bond rate, while all manufacturing earned only 3 percent above.

In 1992, the RBOCs had almost $60 billion of equity. Thus, a net increase of over five percentage points in return on equity translates into an increase in income for the RBOCs of approximately $3 billion per year. This is the core of the excessive returns earned by the Baby Bells.

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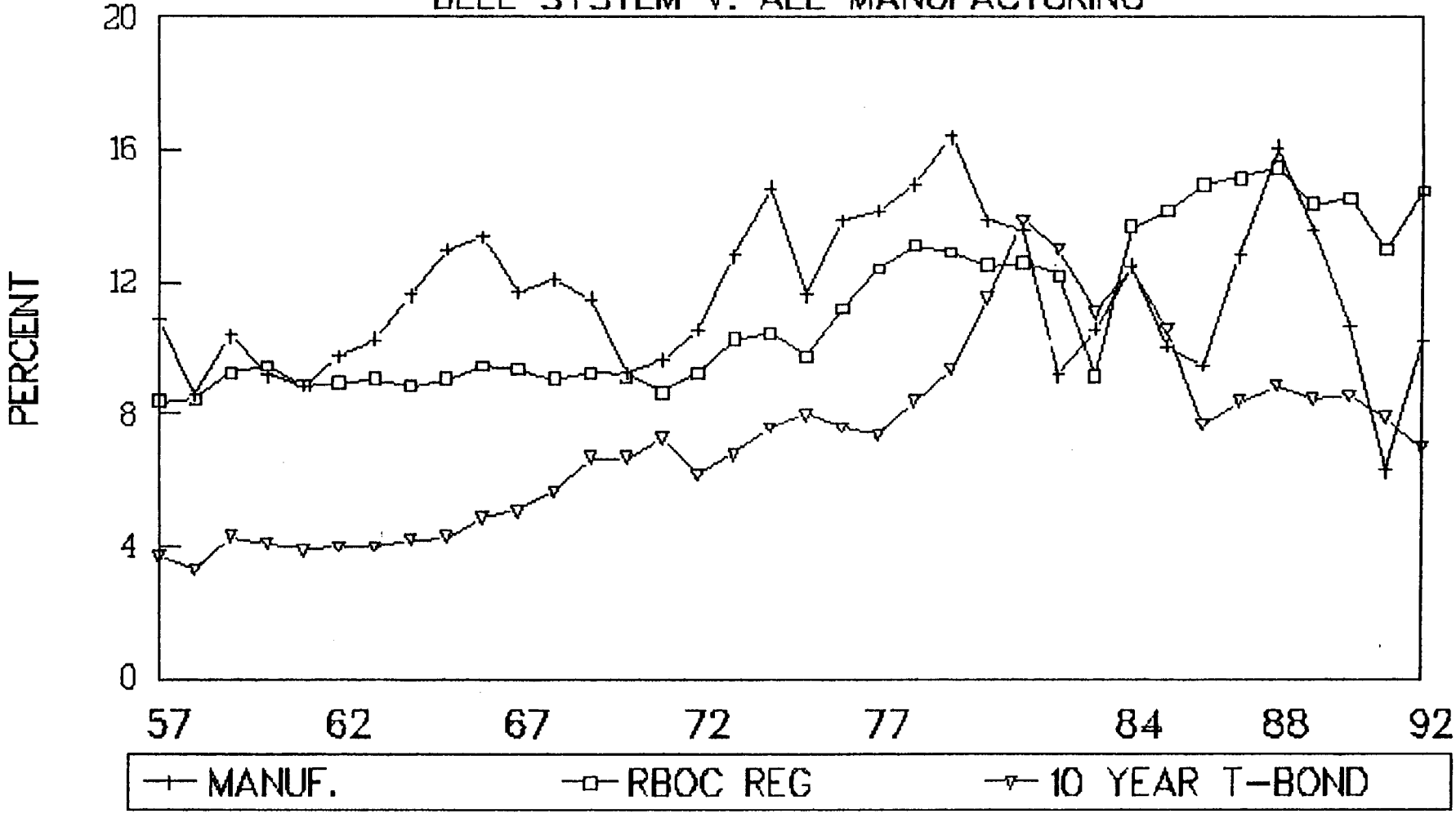
[2] The fact that this return on equity was more than adequate to do the job of attracting capital and providing for a technologically dynamic and economically sound industry has been amply demonstrated in and "Consumer Federation of America... 1987, and "Joint Comments...," 1990.

FIGURE II-1

RETURN ON EQUITY
BELL SYSTEM V. ALL MANUFACTURING



ECONOMIC REPORT OF THE PRESIDENT, STATISTICS OF
COMMON CARRIERS, A. KAHN, UTILITY REGULATION REVISTED

B. RECOGNIZING RISK AND THE COST OF CAPITAL

To a significant degree, the problem of excess earnings has it origin in the fact that the rate of return set soon after divestiture was set at a high level because the RBOCs were new entities and there was some question about how they would fare in the new environment. Experience has shown that local exchange service is low risk and highly profitable. The early concerns were unfounded. To the extent that higher rates of return were allowed in those early days in response to these uncertainties that have been eliminated, rates of return should be lowered today.

Table II-1 shows several measures of the cost of capital from 1984 compared to mid-1993, or 1992, where only annual numbers are relevant. Looking at rates on borrowing, like 10 year treasury bonds or the discount rate, we observe a 6 percentage point decline in the cost of capital. Earnings by the Business Week 1,000 and in the manufacturing sector are down by 2 to 3 percentage points.

TABLE II-1

CHANGES IN CAPITAL COSTS SINCE 1984

	1984	1993	CHANGE
LOAN RATES			
3-MONTH T-BILL	11.8	3.0	-8.8
10-YEAR T-BOND	12.4	5.4	-7.0
DISCOUNT RATE	8.8	3.0	-5.8
PRIME RATE	12.0	6.0	-6.0
RETURN ON EQUITY			
ALL MANUFACTURING	12.5	10.3	-2.2
BUS. WEEK 1,000	13.2	10.4	-2.8
RBOCS	13.7	14.5	+ .8

SOURCES: Economic Report of the President: 1993; Monthly Economic Indicators, various issues; Business Week 1,000, various Special Issues; Federal Communications Commission, Statistics of Communications Common Carriers, various issues.

The rate of return earned by the RBOCs has simply not come down. This has resulted from a vigorous campaign conducted by the RBOCs. They have resisted coming in for rate changes in states where the Commission does not have the authority to force rate reductions. They have pushed for deregulation of profits in states where the

Commission has such authority.

In short, the Baby Bells exploited the uncertainties of divestiture to increase rates in 1984/85 and have fought a guerilla war to prevent them from coming down since. In fact, in many states the full benefit of the reduction of the corporate tax rate in 1986 was never passed through to consumers.[3]

C. COMPETITION AND THE RATE OF RETURN

The dramatic increase in rates of return sustained over the decade since divestiture flies in the face of the RBOCs' argument that competition is eroding their market power. Their argument rests on the assertion that competition makes it impossible for regulators to continue to practice traditional, rate of return regulation because competition threatens revenue streams and profitability.

The flaw in the argument is that there is no competition for the vast majority of services provided by the local exchange companies. Looking back over the period since divestiture (see Figure II-2), we find that local service revenues have been growing as fast in recent years, when competition was supposed to be growing, as immediately after divestiture.

At a more micro-level, it is clear that the vast majority of LEC revenues come from services that are not currently threatened by competition. These include the monopoly core business -- i.e. local exchange service and associated access charges. Here we can also include some of the so-called competitive services in which the technology deployed, access to customers, and/or the monopoly local exchange service give the company a large advantage. Included in this category are Custom Calling features, residential long distance, residential customer premise work, Yellow Pages, high capacity private line, and Centrex.

The claim that earning power is being eroded by competition is also undermined by a comparison between RBOC earnings and those of their purported competitors, as Table II-2 shows. We have included the lines of business identified by most analysts as being part of the information age. These are the areas in which the RBOCs claim to be facing competition for one or more of their services.

The return on equity earned by these potential competitors over the past five years, as calculated by Forbes, and the past three years as published in Business Week

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[3] "Testimony of Dr. Mark N. Cooper," before the Ways and Means Committee, U.S. House of Representatives, December 14, 1987.

FIGURE III-2

LOCAL REVENUES

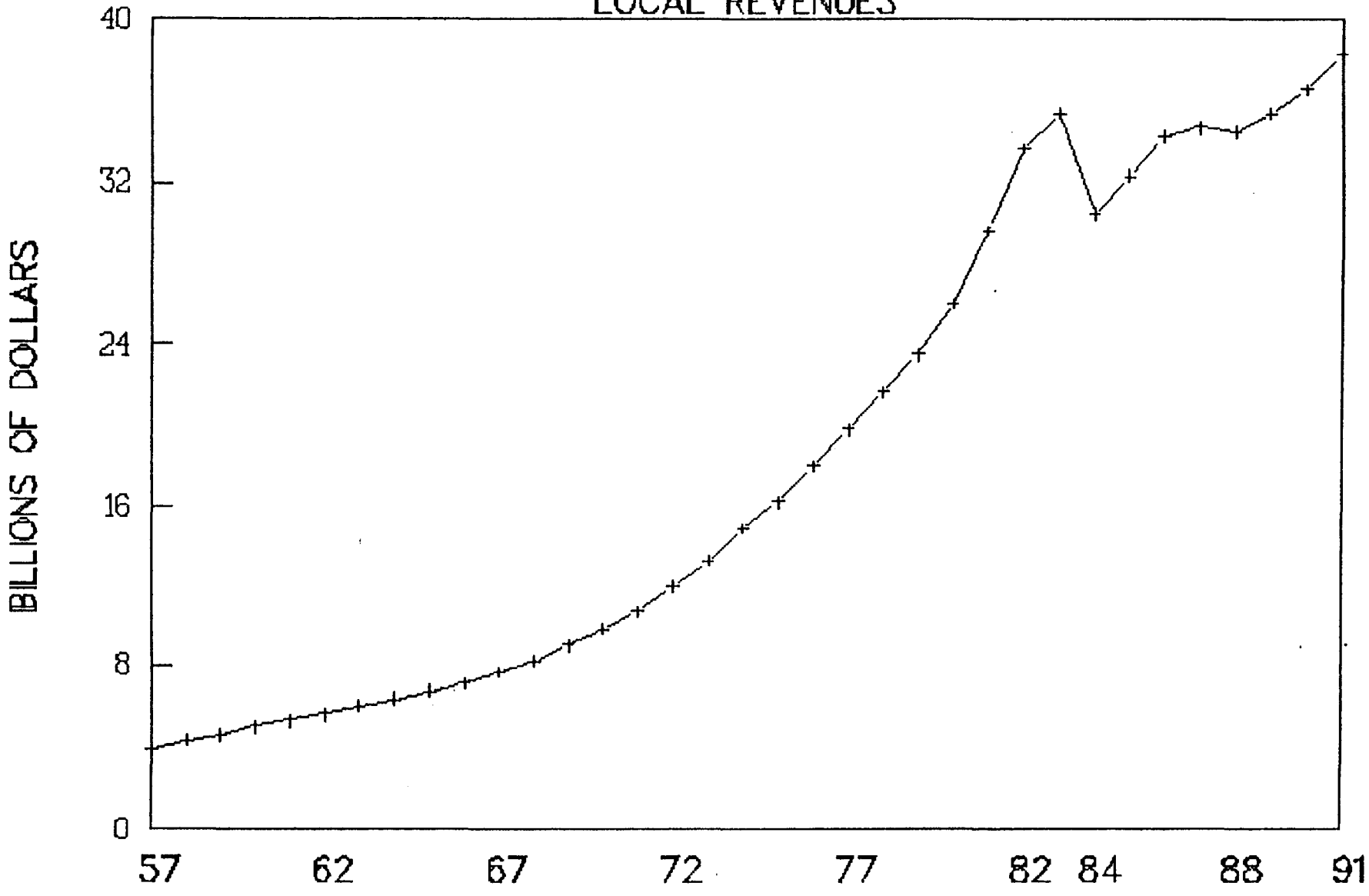


TABLE II-2:
RETURN ON EQUITY AND CAPITAL STRUCTURE FOR LOCAL EXCHANGE COMPANIES, THEIR POTENTIAL COMPETITORS AND OTHER UTILITIES

	FORBES	BUSINESS WEEK			DEBT AS
	1988-1992	1992	1991	1990	% OF CAPITAL
ALL INDUSTRY	11.5	10.4	9.2	12.5	33
BELL BOC AVG	14.5	14.8	13.0	14.6	29
BELL NON-BOC AVG	4.3	2.6	4.9	8.5	85
OTHER UTILITIES					
ELECTRIC UTILITIES	11.4	11.0	10.0	9.7	38
GAS UTILITIES	10.8	10.2	1.1	6.1	40
OTHER LECS					
GTE	15.3	14.4	14.0	12.9	44
SNET TELECOM	12.2	12.9	10.8	11.9	37
ROCHESTER TEL	13.0	11.7	12.9	11.5	39
CINCINNATI BELL	10.4	5.9	6.7	15.5	30
TELECOMMUNICATION	11.5				33
EQUIPMENT		15.4	3.3	15.9	
COMPANIES		14.4	11.5	13.7	
OTHER NON-UTILITIES					
BROADCAST & CABLE	LOSS	5.4	-1.1	5.1	69
MOVIES	6.5	13.6	11.6	12.9	34
PUBLISHING	11.0	6.9	4.7	7.1	18
ADVERTISING	17.4	19.9	14.0	16.0	27
COMPUTER SOFTWARE	19.2	20.9	18.4	20.1	8
COMPUTER HARDWARE	6.4				10
PERIPHERALS	11.7	-10.3	-1.1	11.0	19
CONSUMER ELCTRNCS	12.6				8
HOME SHOPPING	11.0				20

Sources: Forbes Annual Report on American Industry, January 3, 1994; Business Week 1,000, various special issues; Federal Communications Commission, Statistics of Communications Common Carriers, various issues.

is generally lower than that of the RBOCs. Broadcast, cable, movies, entertainment, publishing and computer hardware and peripherals have much lower rates of return.

These are the major areas which are projected to be the core of the information age. Only software and advertising show a higher rate of return.

The table also includes other points of comparison to appreciate just how strong RBOC earnings have been. They have earned much higher rates of return than other utilities, which face even greater competition than they do. They have also earned more than other telephone companies.

D. CONCLUSION

Based on this review of profit performance before and after divestiture and comparisons to other companies in the economy, as well as the potential competitors of the telephone companies, we conclude that there have been excessive profits earned since divestiture. The return on equity has experienced a swing of approximately five points compared to the historical pattern. The result is excessive profits of approximately $3 billion per year.

In the context of a regulated utility service such as the RBOCs, these excess earnings place a heavy burden on rate payers. These are after tax rates of profit and rates are set to include taxes collected from ratepayers. The result is that the revenue requirement associated with these excess earnings is $4.6 billion higher than it should have been.

III. WHERE DOES ALL THE MONEY GO?

A. TAKE THE MONEY AND RUN

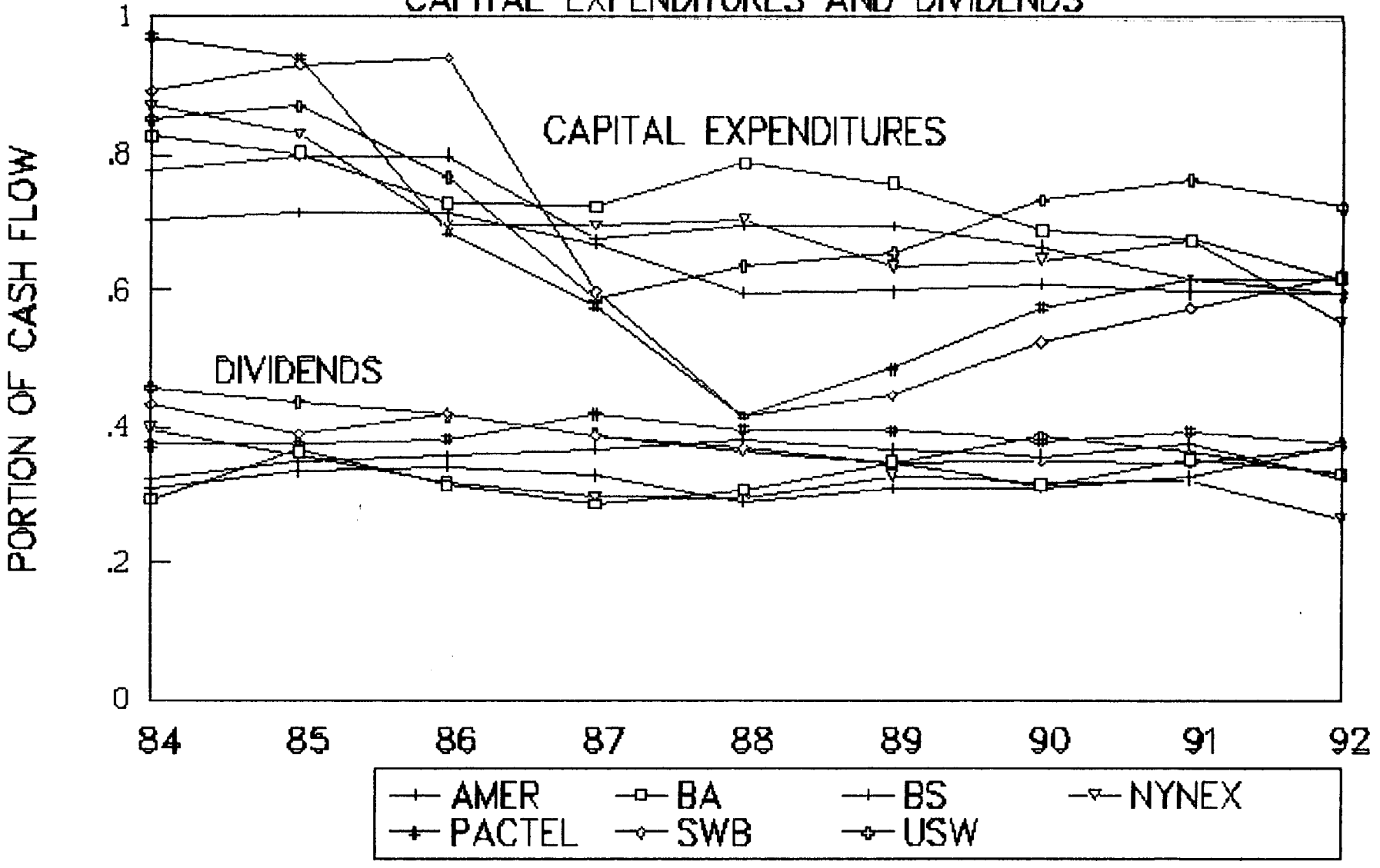
One of the major claims made by the RBOCs to support their campaign for higher earnings, alternative regulation and entry into other businesses is the assertion that incentives would encourage the companies to seek greater efficiencies in the delivery of services and more rapid deployment of infrastructure. However, it should be recognized that rather than pursue efficiencies through investment, companies might choose to take their money and run, diverting it to unregulated activities. With the availability of immediate returns, they could simply increase current profits and cash flow, rather than reinvest in the network.

An analysis of the use of cash flow by the RBOCs gives strong indication that this is what they have done. As Figure III-1 shows, capital expenditures as a percent of cash flow have declined.

The numbers are quite large. The BOCs have enjoyed an increase in cash flow

FIGURE III-1

RBOC CASH FLOW USED FOR
CAPITAL EXPENDITURES AND DIVIDENDS



of more than $7 billion, yet they have increased capital expenditure by a little more than $1 billion. In short, there has been a massive throw off of cash. In fact, since 1986 capital expenditure has decline three quarters of a billion dollars, while cash flow has increased by over $1 billion. In the last several years, capital expenditure has been approximately equal to depreciation, indicating no new net investment in the network.

We also observe this problem at a more micro level. Appendix A presents the results of an econometric study of the impact of increases in income and alternative forms of regulation on the deployment of specific technologies. We find that there is virtually no relationship between either alternative regulation or higher levels of income and the deployment of digital switches, SS7 or fiber optic cable. This is consistent with the observation that the companies tend to take the money and run.

B. EXCESSIVE DIVIDEND PAYOUT

The increase in cash flow which has not been put back into the network has been thrown off in the form of dividends and acquisition of unregulated assets as Figure III-1 shows. In contrast to capital expenditure, which declined as a percentage of cash flow, the RHCs increased dividend payout as rapidly as cash flow increased.

Dividend payments have increased by over $2.5 billion per year since divestiture. In essence, the RHCs have maintained their dividends at about one-third of cash flow. The dividends paid by the RHCs are quite high compared to other businesses as Table III-1 shows, at over twice the average of Business Week 1,000.

TABLE III-1:
DIVIDEND YIELD: RBOCS COMPARED TO OTHER CORPORATIONS

	1984	1985	1986	1987	1988	1989	1990	1991	1992
AMERITECH	7.3	5.5	5.5	5.8	5.7	5.2	5.3	5.9	5.0
BELL ATLANTIC	7.7	5.5	5.1	5.4	5.5	4.8	4.9	6.0	4.8
BELL SOUTH	7.4	5.4	5.0	5.5	5.8	4.6	5.2	6.1	5.0
NYNEX	7.6	5.5	5.0	5.6	5.8	5.4	6.0	6.3	5.1
PACTEL	7.1	6.4	5.5	5.6	5.1	4.1	4.8	5.4	4.7
SW BELL	7.2	6.6	5.4	6.1	5.6	4.7	5.1	4.9	3.9
US WEST	7.6	5.9	5.4	6.1	5.8	5.2	5.2	6.2	5.1
RBOC AVG.	7.4	5.8	5.3	5.7	5.6	4.9	5.2	5.8	4.8
BUSINESS WEEK	3.2	2.8	2.4	2.8	3.0	2.9	2.8	2.4	2.1

SOURCES: Business Week, Scoreboards issues.

C. DIVERSION OF CASH INTO NON-TELEPHONE BUSINESSES

The second primary use of these excess earnings and cash flow has been to funnel them out of the industry and into the acquisition of over $35 billion in unregulated assets -- everything from real estate to foreign exchange deals. Table III-2 shows a conservative estimate of the throw off of resources from the RBOCs. It is conservative because it includes only the current (year-end 1992) non-BOC assets held by the RHCs. Many of the RHCs have thrown cash off into very bad non-telco investments, which have already been written off. Including those losses would push the total of assets acquired close to $40 billion.

TABLE III-2:

NON-TELCO ASSETS OF REGIONAL BELL HOLDING COMPANIES
AS OF DECEMBER 31, 1992
(Millions of Dollars)

US WEST	7495
BELL ATLANTIC	6087
SOUTHWESTERN BELL	5951
SOUTHERN BELL	5021
NYNEX	3794
AMERITECH	3499
PACTEL	3334

SOURCES: Federal Communications Commission, Statistics of Communications Common Carriers, 1992/93

The result of this pattern of investment is to dramatically alter the nature of the RHCs at the expense of rate payers as Table III-3 shows. Since their creation in 1984 the RHCs have been among the most profitable corporations in the country. They have earned about $74 billion. The RHC profitability is made up of about $72 billion in income from telephone operations and $2 billion in income from non-telephone operations. They have used this income as follows: $49 billion in dividends to stockholders, $16 billion in investment in non-telco activities, $13 billion in net investment in telephone infrastructure. Thus for every $1 of net new investment in telephone operations since divestiture, there have been $1.25 of investment in non-telco operations and $3 of dividends.

Following the money in 1987-1992 gives a much sharper image of where the Baby Bells are going. They have used their income in recent years as follows: $35 billion in dividends, $13 billion to non-telco activities, $1 billion in net telco investment.

TABLE III-3:
REGIONAL BELL HOLDING COMPANY ECONOMIC ACTIVITY

USES OF INCOME ($, BILLION)	1984-92	1987-92
TOTAL INCOME	74	51
DIVIDENDS	49	35
NON-TEL INVESTMENT	16	13
NET TELCO INVESTMENT	13	1

ASSET MAKE-UP ($, BILLION)	1984	1987	1992
TOTAL	137	162	182
TELCO	127	145	146
NON-TELCO	7	17	36

LABOR MAKE-UP (000)	1984	1988	1992
TOTAL	568	560	515
TELCO	NA	468	410
NON-TELCO	NA	92	105

Source: Federal Communications Commission, Statistics of Communications Common Carriers, various issues; company annual reports.

Thus, for every $1 of net new investment in the network, there have been $13 invested in non-telco activities and $35 of dividends. Of course, the companies spent a lot more than $1 billion on the public switched network in the last five years, but that was all funded with depreciation, yielding virtually no net increase in investment.

As a result of this shift of investment, there has been a radical change in assets. Today, over one-fifth of the total assets of the Holding companies (some $35 billion) are in non-telco assets.

Jobs follow the money. Between 1984 and 1988, employment in the holding companies was constant. Since then, there has been an 8 percent decline in employment. However, jobs in telco operations have declined by 12 percent, while non-telco, largely non-union, jobs have increase by 12 percent. Today, one out of every five jobs in the

holding companies is in non-telco activities, which parallels the asset configuration.

D. THE FAILURE OF NON-TELEPHONE COMPANY ASSETS

The $35 billion of assets in non-telco holdings have performed badly. These assets have a net income of just $2 billion over the period. Figure III-2 shows that the unregulated assets of the RBOCs have performed poorly. The average return on equity is less than 4 percent. The poor performance of these assets makes it clear that the regulated, monopoly companies are the source of financial resources for his expansion. These non-performing assets have been sustained by the income producing monopoly assets.

There have been some monumental failures, such as U.S. West's forays into the real estate business in the mid-1980s and NYNEX's foray into equipment services. Bell Atlantic, the leader of current efforts to merge the cable and telephone industries, has accumulated $6 billion of unregulated assets, which have a net loss of about $700 million.

IV. LEVERAGING THE MONOPOLY BASE TO FUND UNREGULATED BUSINESS

There is yet another way in which the rate payers and potential competitors of the local exchange companies have been abused by RBOC financial manipulations.

A. EXCESS BOC EQUITY TO UNDERWRITE RISKY NON-BOC VENTURES

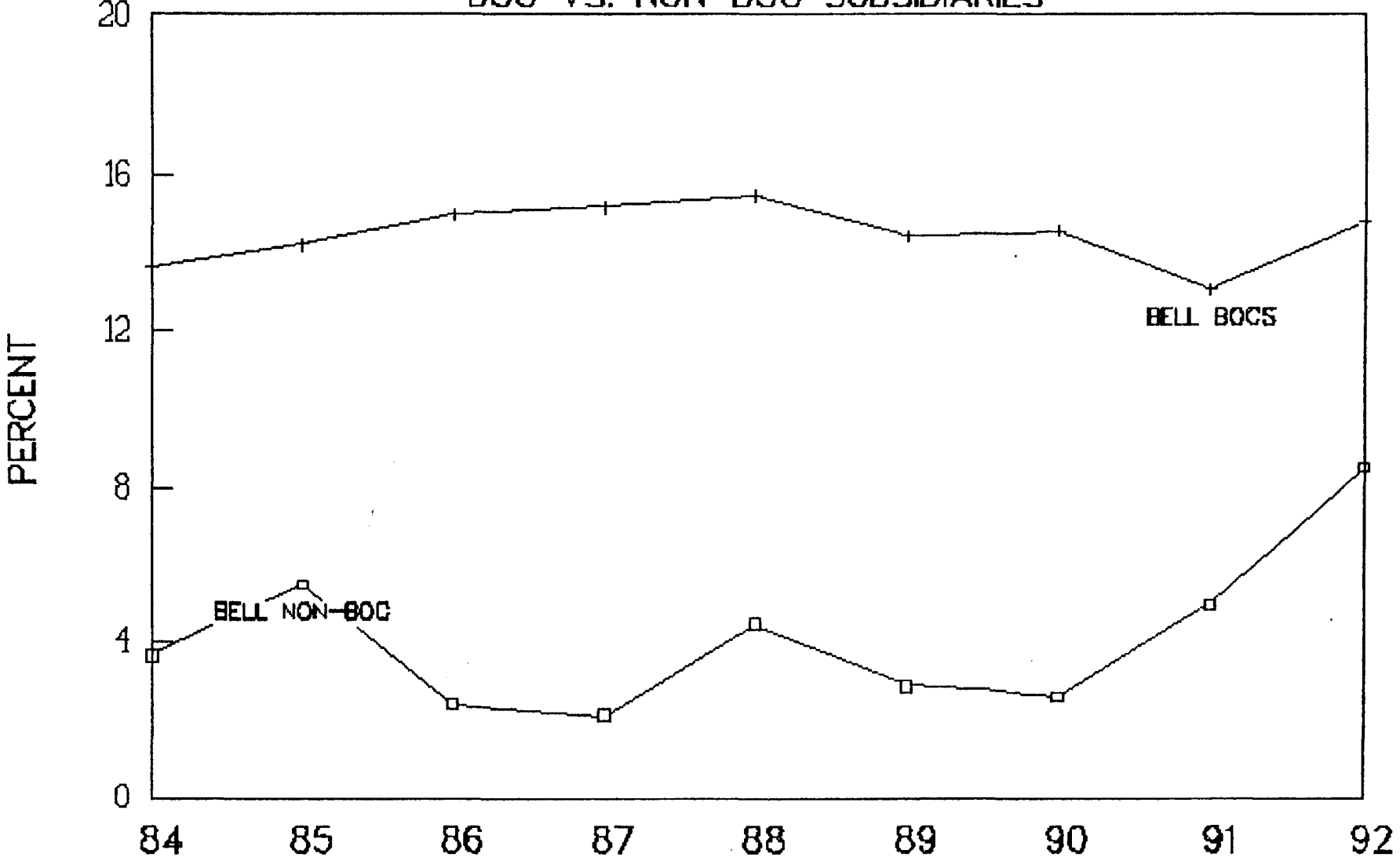
The financial reports of the companies identify approximately $16 billion in cash which has been directly invested in the non-BOC assets. That is, the difference between dividends paid by the BOCs to the RHCs and the dividends paid by the RHCs to their stockholders is just over $15 billion. The total invested in non-BOC lines of business is just over $15 billion.

However, the monopoly ratepayer has been responsible for far more of the total, non-BOC assets acquired by the RHCs. The RHCs have manipulated the capital structure of their subsidiaries and used the BOCs to leverage debt of the non-BOCs. The result is that cash flow from monopoly ratepayers underwrites borrowing in the non-BOC entities.

The capital structure of the subsidiaries is entirely within the control of the RBOC management. Over the years since divestiture the capital structure has been changed by

FIGURE III-2

RETURN ON EQUITY
BOC VS. NON-BOC SUBSIDIARIES



corporate policies to reduce debt (relative to equity) in the BOCs (even though interest rates have been plummeting since 1984) and increase reliance on more expensive equity through retained earnings. In 1984, the RBOCs carried $48 billion in equity and $36 billion in long term debt, plus $26 in deferred long term obligations (taxes). Today they carry $59 billion in equity and $36 billion in debt, plus $32 billion in deferred obligations. Thus, equity has been increased in relation to long term debt.

Figure IV-1 shows the ratio of equity to long term debt in the BOC and Non-BOC subsidiaries (excluding deferred taxes). The difference is startling. The BOCs carry twice as much equity in the BOC subsidiaries as in the Non-BOC subsidiaries.

One would normally expect the opposite to be the case. Markets would insist on higher equity capital at risk in the more risky unregulated ventures, which, as we have seen, have performed poorly. Risky ventures that are highly leveraged, as the RBOCs unregulated activities are, would require very high interest rates.

B. THE SUBSIDY FROM RATEPAYERS TO STOCKHOLDERS AS A COMPETITIVE ADVANTAGE

The core monopoly businesses have been used to carry much higher levels of equity, raising the cost of capital for ratepayers, but also providing a stable return to investors, while the risky unregulated businesses have been financed with debt, which is guaranteed by monopoly cash flow. The RBOCs get away with low equity ratios, without raising the cost of their debt dramatically, by having the ratepayer absorb the risk in the form of excess equity retained in the operating companies.

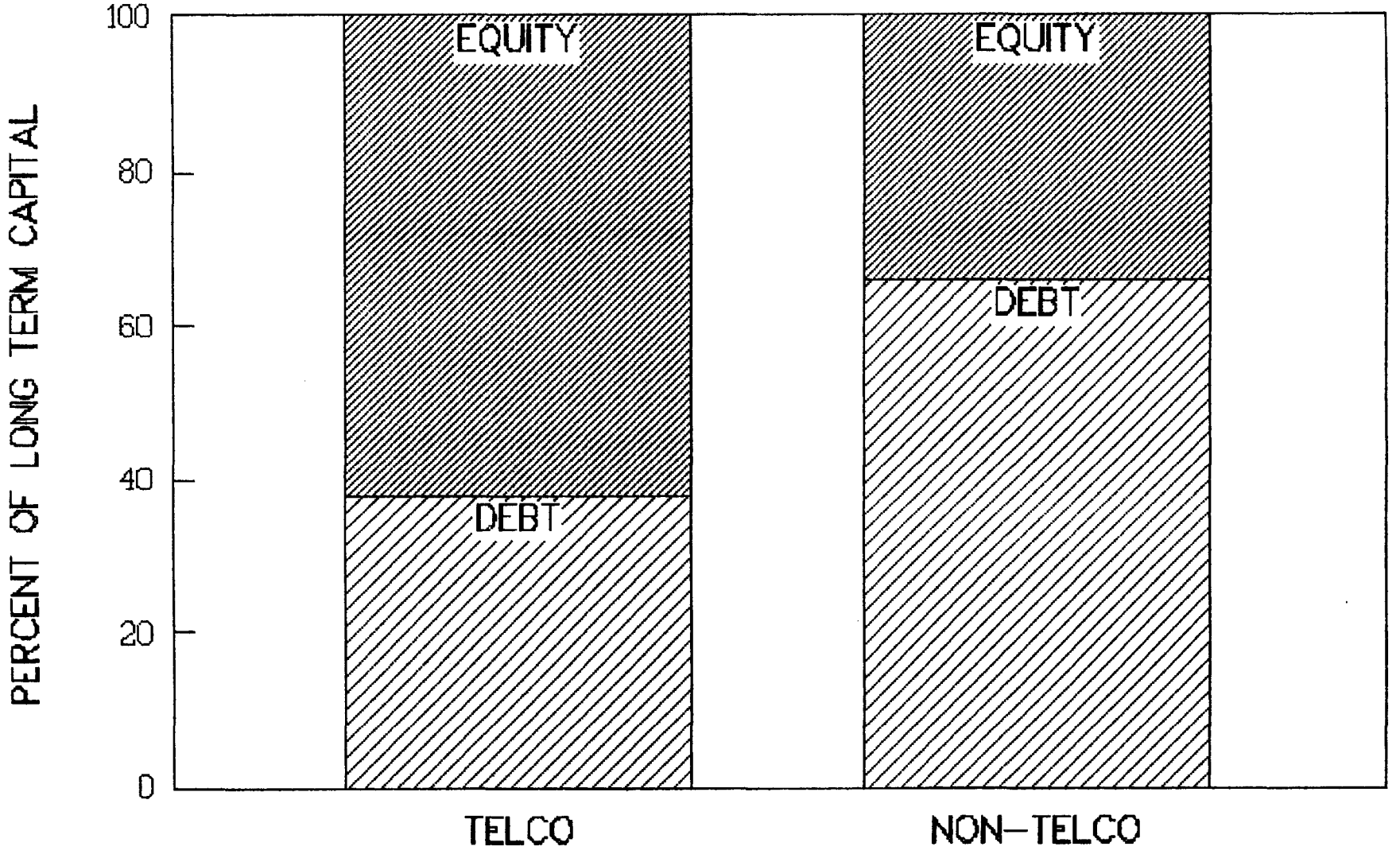
This creates high revenue requirements, large amounts of free cash for the holding company and stable earnings tied to the monopoly business. The dividends paid by the operating companies to the parent holding company have exceeded the total dividends paid by the company to shareholders. The excess dividends transferred to the parent exceed the total debt of the unregulated subsidiaries.

Thus, not only does the parent guarantee the debt, but it has the cash flow from the operating telephone companies to back up the guarantee. The result is favorable overall financials and plenty of free cash to ensure that debt payments for the unregulated company will be covered by dividends from the operating company to the parent.

The result of this subsidy is to give the RBOCs a tremendous financial advantage as they move into competitive businesses. Table II-2 above shows the capital structure of the BOCs, the Non-BOC subsidiaries, and other types of companies in the economy. As with the financial analysis, we include both utilities, which are the standard of comparison for the monopoly telephone business, and the information industries, which are the standard for the non-BOC subsidiaries.

FIGURE IV-1

DEBT/EQUITY RATIOS OF TELEPHONE AND NON-TELEPHONE SUBSIDIARIES



The BOC subsidiaries have a very low level of debt compared to utilities -- just 29 percent. The non-BOC subsidiaries have a very high level of debt -- compared to non-utilities -- approximately 85 percent. Only the Cable/Broadcasting category comes close, and that is still much lower than the non-Boc subsidiaries of the RHCs.

In spite of this extreme leveraging, non-BOC debt still pays market rates (about 7 to 7.5 percent). There is no doubt that the monopoly ratepayer and potential competitors are being abused in this process. Ratepayers are used unfairly to guarantee the debt of the non-BOC business. The competitors could not get away with the capital structure, which results in lower costs for the BOCs, because they do not have a monopoly ratepayer base to leverage.

V. CONCLUSION

A. THE MAGNITUDE OF THE EXCESSES

The manipulation of capital structure to support the expansion into non-telephone businesses places additional burdens on ratepayers (see Table V-1). Public utility commissions have traditionally insisted on debt equity ratios in the vicinity of 50/50 for the monopoly lines of business.

TABLE V-1:
ESTIMATING THE TOTAL REVENUE EFFECT OF EXCESSIVE EARNINGS AND LEVERAGING MONOPOLY RATEPAYERS

	BILLION DOLLARS	ROE		INCOME FACTOR		TAX RQT		REVENUE
CURRENT EQUITY	59	x .145	=	8.55	X	1.55	=	13.25
REASONABLE EQUITY	48	X .10	=	4.80	X	1.55	=	7.44
DEBT INCREASE	11	X .07	=	.77	X	0	=	.77
TOTAL								8.21
NET REDUCTION								5.04

If the BOCs had been held to such a ratio, they would have been able to lower the revenue requirement significantly, since low cost debt would replace higher cost

equity in the capital mix. The equity part of the capital structure would be reduced by approximately $11 billion. This would lower the net income, compared to 1992, by approximately $1.6 billion at the 15 percent return on equity enjoyed by the BOCs in 1992.

As Table V-1 shows, the overall excessive earnings enjoyed by the RHCs as a result of excessive profitability and excessive equity in the capital structure is approximately $4 billion, at a reasonable rate of return on equity of 10 percent and a 50/50 capital structure. The revenue requirement would be lowered by approximately $5 billion, when tax effects and increased interest expense are taken into account. The cost is almost $5 per month for every residential subscriber.

B. THE IMPLICATIONS OF THE ANALYSIS

In the current policy context, however, as Congress moves to amend the Communications Act of 1934 and speed the construction of the information superhighway, telephone company excess profitability takes on greater significance than the burden it places on household and business budgets and the misallocation of resources.

- The excessive profitability and cash flow currently enjoyed by the RBOCs is just one further indication that they do not face competition at one of the key intersections of the superhighway, the local exchange switch.

- The abuse of cash flow suggests that giving BOCs additional incentives to invest could be money for nothing.

- Further, monopoly control over the local switch could combine with the excessive cash flow to allow a private monopoly to amass significant market power over the information superhighway.

The presence of one of the Baby Bells at the core of each of the alliances seeking to create a megafirm to own and operate the superhighway attests to this potential. The Baby Bells have the money and control a key point of monopoly control on the superhighway. Without proper oversight over their activities, they will amass and abuse a great deal of market power.[4]

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[4] The pattern of abuse of market power by the Baby Bells has been documented in Cooper, Divestiture..., 1991.